Memorandum

To : Mr. Edward W. King
Excise Tax Division

Date : June 11, 1990

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EXCISE TAX DIVISION

From : David H. Levine
Tax Counsel

Subject: Insurance Tax Penalties for Self-Reported Taxes

(Reference:)

This is in response to your memorandum dated May 3, 1990. Currently, when an insurer files an amended return showing a higher tax liability than on the original return or otherwise notifies the Department of Insurance that the insurer owes additional taxes, the Department proposes to the Controller automatic penalties pursuant to Revenue and Taxation Code sections 12258 and 12631. The Excise Tax Division staff regards these self-reported errors as coming into the possession of the Department pursuant to section 12421. This would mean that the Department should propose the self-reported underpayment as a deficiency assessment under section 12422. Penalties would apply only if the deficiency assessment were not timely paid or if negligence or fraud were established. You ask our opinion. I will first respond to points set forth by the Department and then set forth my analysis.

Department's View

Excise Tax Division's view was proposed to the Department in a memorandum from Mr. E. V. Anderson dated June 27, 1989. Mr. Levi Lacuesta of the Department responded in a memorandum dated July 17, 1989. Mr. Lacuesta points out that, under our proposal, the Department, as opposed to the Board, would be determining negligence which Mr. Lacuesta believes is not necessarily contemplated under the statutory scheme. I disagree. Section 12634 provides that when a deficiency assessment proposed by the Department under section 12422 is due in any part to negligence or intentional disregard on the part of the insurer, a penalty of 10% of the amount of the deficiency assessment shall be added thereto. I believe that this provision contemplates that the Department would usually be the state agency to make a preliminary finding of negligence and recommend a penalty based thereon. If the insurer contested the preliminary finding of negligence, the Board would then make a final determination as to whether the insurer had been negligent. The same analysis applies to penalties applicable to prepayments. (See Rev. & Tax. Code § 12258.)

Mr. Lacuesta contemplates three scenarios that may result from adopting the proposal set forth in Mr. Anderson's June 27, 1989 memorandum. One is that penalties may be avoided by insurers because it is very difficult, if not impossible, to prove negligence under section 12634. I again disagree. As you know, the negligence penalty is regularly applied, when appropriate, in administering the Sales and Use Tax Law. That it may be difficult to make the preliminary finding of negligence with respect to the Insurance Tax Law due to the staffing of the Department and the method of its operation does not mean that administration of this tax should be based upon difficulty rather than statutory requirements. As the agency charged with the audit functions of this tax, it is the Department's responsibility to make the preliminary finding of negligence. If the Department does not make such a preliminary finding, it should not recommend a negligence penalty.

Mr. Lacuesta also believes that companies may be enticed to underpay their tax liabilities because they will be able to pay as little as they want and then pay the balance at a later date without incurring any penalty unless negligence is proven. Although this is true, this again relates to the point made above. It is the Department's responsibility to make that initial determination. Further, under the circumstances that Mr. Lacuesta contemplates, I believe that the fraud penalty may be applicable. If the Department notes a decrease in tax reporting compared to what the Department expects the insurer to report, the Department is on notice and, perhaps, should investigate. Mr. Lacuesta also believes that this will increase the number of cases to be processed as deficiency assessments. Although most companies act in good faith and will not abuse the system, if they do so, application of the negligence and fraud penalties should put a stop to it. Again, administration of the tax must be based upon statutory provisions and not merely on ease of administration.

Mr. Lacuesta's third point is that this will further clog up the system because, if the Department proposes deficiency assessments on these cases, the insurers can further delay payment by filing a petition for redetermination and, if that is denied, by filing a claim for refund. He believes that under the present procedure, insurers can seek relief for the penalty only under section 12636, and once that is acted upon, that might be the end of it. I do not agree. Under any circumstance, the insurer may file a claim for refund, whether the payment was pursuant to a deficiency assessment or pursuant to the initial return. Although treating self-reported deficiencies as deficiency assessments may enable insurers to file petitions for redetermination, this does not appear likely. First, since the

insurer self reported the deficiency, presumably the insurer agrees that it owes those taxes. Second, under such circumstances, it appears that the only advantage that an insurer would have for filing a petition for redetermination would be to delay payment of the tax. However, if the tax is upheld, the insurer would owe interest from the due date of the tax. Since many insurers pay taxes owed under a deficiency assessment even when filing a petition for redetermination in order to stop interest from running, it does not appear too advantageous to delay payment when it is certain to be owed.

Mr. Lacuesta also notes that it takes time to propose a deficiency assessment because it needs full documentation. I believe that the documentation from the insurer by which it self reports the deficiency is sufficient documentation upon which to base a proposed deficiency assessment.

Analysis

My understanding is that my analysis, as set forth below, is consistent with that of the staff. Section 12412 provides that upon receipt of the copy of the return of the insurer, the Board makes the initial assessment of tax in accordance with the data reported on the return. There is only one initial assessment of tax, and that initial assessment is not changed no matter what further information is received. When an insurer files an amended return or otherwise informs the Department that the insurer's initial return reported too little tax, that information is information coming within the possession of the Department and is regarded as part of the Department's examination of the insurer's return. Since the Department would therefore determine that the amount of tax disclosed by the insurer's return and assessed by the Board is less than the amount of tax disclosed by the Department's examination, the Department shall propose in writing to the Board a deficiency assessment for the difference. (Rev. & Tax. Code § 12422.) Based on this proposal, the Board would issue a deficiency assessment under section 12424.

There is no statutory provision for changing an initial assessment except by issuing a deficiency assessment. Therefore, there is no provision to regard the insurer's self reporting, after the due date of a timely filed return, as a late payment subject to the penalty assessed under section 12631. That section specifically excepts a tax determined as a deficiency assessment by the Board. I believe that the payment at issue in this type of situation is such a tax and is not subject to the automatic penalty of section 12631. If the Department believes that such a late payment is due to negligence or fraud, it should

recommend such a penalty. If the insurer disagrees with the Department's preliminary finding, it may contest the penalty.

If you have further questions, feel free to write again.

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